GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Recession

Why are people so afraid of the word? It's really only a bad word for those who have made bad investments or who are in industries that are oversupplied relative to demand. Personally, I view recession like I view winter. I don't like it but I use it as an opportunity to prepare for the good times to follow.

It's going to take a few years but there are going to be some exciting times ahead for investors. Changes in transportation technology, a return of manufacturing, new energy ideas, and population migration to areas of opportunity are among the exciting themes that we see in our future.

After years of anticipating and planning for this downturn, I'm pleased to be able to start moving back to what we do best – focusing on valuable long term investments. But first, we've got to get through the current mess.

Banks

The whole financial system in our country is an absolute mess and likely to get much worse. We saw this coming four years ago and sold all of our bank stocks because it was obvious that banks were making credit decisions that were so indescribably stupid that a systemic crash was inevitable – and now it's here.

The fall of Bear Stearns is just another step in this systemic crash. In my opinion, had Bear gone down without the Fed and JP Morgan bailing them out, we would have had a Black Monday in the stock market because Wall Street is like a game of dominoes. They all lend to and trade with each other making them mutually dependent counter parties; the fall of one would bring down others. I consider the save to be a brilliant move by the Federal Reserve, albeit one where they legally overstepped their bounds.

Notice the chart below of banks and where we sold our position. Sure we were early, but aren't you glad we saw this coming?

I've seen a number of pundits claim that it's time to buy bank stocks and I disagree strenuously. Some banks are permanently impaired although their stocks are still trading, while most of the others will be a minor shade of what they are today when this drop finally hits bottom.

In short, the whole asset inflation game where banks made indiscriminate loans to anyone with a pulse is over and it's not coming back. Most banks will return to being low growth, relatively commoditized entities if they survive this downturn. There will be a time to buy them, but it's not today.

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Housing

We will hit the bottom of the housing market when homebuyers at the median income for a county can buy a house valued at the median for that county with 20% down and monthly payments that don't chew up their paychecks.

Unfortunately, that point is a long way down from here because bad lending decisions increased the total amount of money thrown at the housing market which temporarily drove up the value of homes. The immediate future of the housing market will be a dark one but it won't be the end of the world.

If you want, you can read stories about housing until your head spins but this mess won't get fixed until the average buyer can comfortably afford a home. So for your own peace of mind, ignore the placebos coming out of Washington and Wall Street and wait for common sense to prevail.

Gold

Our investment thesis on gold from our initial purchase at $429 per ounce was that the Federal Reserve would inject massive amounts of money into the banking system to stave off a crisis in our economy with the result being a dramatic drop in the value of the US dollar versus our trading partners. The investment has worked out beautifully as gold is now at $930 an ounce, down from $1,020 in mid-March.

It's working because the Fed is doing exactly what we expected that they would do. In fact, I continue to believe that Ben Bernanke was given the top job at the Fed because of his theories on flooding the banking system with cash to avert crises.

Notice the chart that essentially mirrors our holding period for gold and you can see how these expectations are playing out.

There will be a time to cut back on our unusually large positions in gold but while the Fed continues to inject obscene amounts of money into the banking system to fend off systemic problems, an overweighting of gold makes sense.

Inflation

Rising prices are a symptom of and not a cause of inflation. A better term for inflation is devaluation of the currency. Prices are higher because that dollar in your pocket isn't worth as much as it had been a year ago. This has actually been going on much longer than the past few years but cheap imports from Asia have obscured this trend until recently.

Over the next year, I expect this situation to get worse because the Federal Reserve is cutting interest rates aggressively despite rising prices – the exact opposite of what you would normally expect. Have you ever wondered why the Fed cut interest rates to 2% when the official inflation rate is 4%? In essence, the Fed is choosing to devalue the currency in an effort to save our banking system.

And here is the result of their efforts. Notice how the value of the dollar has been almost cut in half over the past six years.

But we're not alone – inflation appears to be worse in much of the world. Both official and anecdotal evidence indicates food, electricity, coal, water, and gas rationing in China due to prices rising so fast, the government is afraid to pass them along to angry consumers.

In Egypt, food prices are rising so fast that the government is considering doubling the minimum monthly salary to help, in addition to subsidizing the price of bread.

The knee jerk reaction for many speculators is to rush into the commodities as they are the ones that have price elasticity but I've always remained a believer that every great rally in market value sows its own seeds of destruction. Consider how much less you are buying because you're paying up for milk. Think about how many would-be capitalists will be planting crops next year to take advantage of higher prices.

People adapt to paying higher prices for essentials. Some will purchase a smaller car, or eliminate discretionary travel altogether. Some will plant gardens to combat the high price of fresh vegetables. Just about everyone will cut back on those little luxuries that have crept into our monthly budgets – the CEO of Starbucks is visibly frightened of this prospect.

I've read where many pundits believe that continued growth in emerging economies will make up for a weak US consumer. But will they be able to make up for weak European consumers, weak Japanese consumers, weak Chinese consumers, weak Egyptian consumers and weak Indonesian consumers?

The answer is that high commodity prices will seriously weaken the global economy. The good news is that I believe places like China will get hurt much worse than we will in the US and take much longer to rebound. The market seems to agree – notice the drop in the Chinese stock market. I hope you took our advice last year and sold.

Prepare for higher prices for the next couple of years but realize that market dynamics will ultimately bring them down again.

The Bond Market

Investors want to own US Treasury bonds, the stuff we've been buying for the past four years, and they don't want to own anything else. Bond investors are scared because there is so much garbage floating around trading desks that it's hard to trust anything Wall Street sells you.

Getting this right will take patience because I believe that worsening inflation data will drive up long term interest rates, hopefully giving us an opportunity to move out of short term instruments.

Right now, the government is telling us that inflation is 4%, yet the 10 year US Treasury bond is yielding 3.5% which means that investors are locking in a negative 0.5% real rate of interest. At a minimum, this bond should be yielding 5.5% to 6.0% to compensate for inflation but since everyone wants the safety of Treasuries, they're willing to lose a little instead of losing a lot. Buyers of this bond today face a substantial loss if long term rates rise.

Some others are willing to accept the risk of buying securities of Fannie Mae and Freddie Mac, the two giant mortgage agencies believing that the Federal government will bail out their bonds no matter how bad the housing market gets. This may be true, but I suspect both companies are technically insolvent if their balance sheets were truly "marked to market" and I can't bring myself to buy the bonds of entities that I believe are insolvent.

Buyers of short term Treasuries are experiencing a bigger short term loss, but face no risk of a substantial loss. At GeoVest, we're willing to accept the paltry returns for the time being because we believe that further inflation scares will give us the opportunity to buy high quality, longer dated paper at rates that reward us for inflation risks.

As tempting as it is to "reach" for higher yields, history tells us that those who reach must assume higher risk. In the present environment, it's not advisable to take a blasé approach to risk.

The GeoVest Approach

The downturn that we've forecasted has arrived and there is a good chance that it will be a sharp one. Our plan for the next year is to preserve capital while taking advantage of a few trading opportunities. Our goal is to produce positive returns, regardless of the market environment.

Ultimately, our economy is going to turn back to expansion mode, probably around the time when Wall Street has collectively given up. That will be the time to get aggressive.

In the meantime, I hope to introduce some of our new ideas in our quarterly newsletters to stay focused on the benefits of long term investment and to assure you of our preparedness. As always, I will strive to give you an unfettered look at what is really going on.

Our clients have been remarkably supportive of us during these challenging months as we've largely produced positive returns. But if you would like more updates, I'd be happy to go back to providing regular analyses of this difficult environment on our website. Let us know if this would be helpful because at GeoVest, we never forget that it is our privilege to serve you.

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